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EX PARTE

April 23, 1997

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, DC 20054

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Re: Ex Parte Submission
CC Docket No. 96-262

Dear Mr. Caton

In response to a staff request, MCI submits the attached material, which outlines the mechanisms the Commission can use to bring down access rates which are currently in this record. Please associate it with the record in the above captioned docket.

Respectfully submitted,

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CC: Larry Atlas
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How the FCC Can Reduce Access Rates Based on the Current Record

Reinitialize the price cap to 11.25% or 10%

- Approximately $2 billion reduction if price cap is reset to 11.25%, about $2.7 billion if set at 10%

There is precedent to reinitialize rates both from the original price cap when the authorized ROR was lowered to 11.25%, and from language in that decision that one of the things the Commission would review when evaluating whether the price cap is operating properly is earnings. The most recent earnings numbers, which average about 15% would indicate that the current cap is not yielding appropriate rates, either because it was set wrong initially, the FCC underestimated the productivity of the LECs or a combination of both. An ex parte submission filed April 18, 1997 which includes an evaluation of achieved LEC productivity under the interim price cap plan is attached.

There is also evidence on the record that the cost of capital has declined since the price cap was changed. Initially, LECs claimed it was temporary and could not be sustained, so the Commission should ignore it. However, the cost of capital has remained steady at about 10% for over a decade. At least one state, Washington, has recognized this to be the case for intrastate services and has reduced the authorized rate of return to 9.6%. The same method used by the Commission to calculate the 11.25% ROR in the original price cap decision would today yield a return closer to 10%. In light of the fundamental changes brought on by the 1996 Act and the growing earnings of the price cap companies, significant changes to the LEC price cap are appropriate. Indeed, one of the reason's for reinitialization at the time the price cap was created was that it represented a fundamental change in the regulatory environment.

Legal precedent clearly states that the Commission when, "faced with new developments or in light of reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrative rulings and practice." American Trucking Ass'ns v. Atchison, Topeka, and Santa Fe Ry. Co., 387 U.S. 367, 416 (1967). Furthermore, as long as the Commission supplies a reasoned explanation, it has the authority to adapt rules and policies as circumstances change. Motor Vehicle Manuf. Ass'n. v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 42 (1983). The full memo on this issue was filed as an ex parte on April 7, 1997 and is attached.

Increase Productivity Adjustment

- $210 million reduction per percentage point increase.

The productivity adjustment is supposed to be an incentive to the LECs to become more efficient. The current price cap, with its low productivity adjustments, provides no challenge for increased LEC efficiency. Studies were placed in the price cap docket by AT&T, AD HOC and CARE which indicate true LEC productivity is as much as 10%. In addition, after the interim order was issued, additional analysis submitted by CARE was done using LEC earnings to show what level of productivity a price cap LEC would need to have made to choose a 5.3% productivity factor without sharing. The continuing trend of increased earnings would indicate that even with the modest increases in X factor in the interim order, the price cap is not properly calibrated to yield a reasonable profit or emulate the competitive market.

MCI recently filed an analysis of LEC earnings as an ex parte at your request which indicates the appropriate productivity adjustment would fall between 7.95% and 10.63%. This LEC productivity analysis is filed in response to a flawed analysis submitted by USTA in attachment 7 of its access reform comments which purports to show unbelievably low LEC productivity.

Eliminate the TIC

- $2.8 billion

Based on the remand decision in the Comptel case, the FCC must show that there is an economic basis for the TIC or eliminate it. MCI and others have long maintained there is no economic basis for the TIC, including in our access comments and, a review by the Commission will bear this out. The fact that both NYNEX and Bell Atlantic admit as part of their access plan from AT&T that at least 80% of the TIC cannot be defended as cost based gives the Commission additional record basis to eliminate or virtually eliminate the charge altogether.

Reduce Terminating Access

- $3.8 billion in access reductions if reduced to 1.1 cents . (Both originating and terminating yields $6.5 billion)

A review of ex parte filings by the RBOCs and GTE reveals that incumbents maintain the embedded cost of interstate switched is about $0.011 per minute on each end. While record evidence from the Hatfield model shows the economic cost at less than half of a cent, the Commission can rely on the LEC data to reduce current rates from $0.027 per minute to the level identified by the LECs until a full TELRIC study is complete and rates can be brought down the rest of the way. While there is disagreement about whether originating access is subject to competition, the record is also full of cites indicating that virtually all parties agree that terminating access is a bottleneck under any view. This only strengthens the argument for the Commission to reduce terminating access rates at least down to the level identified by the LECs.

Move Legitimate Universal Service Subsidies Out of Access

- At least $1.6 billion in access reductions would be achieved by moving interstate universal service monies to an explicit USF as required by the 1996 Act.

While there continues to be significant differences of opinion about the exact size of the USF, all parties agree that the need will be at least the $6.6 billion ($1.6 billion = 25%) identified by the Hatfield model. Therefore, the Commission should order the interstate share of those funds moved from the current access charge regime, which is being used in part to subsidize universal service, into the explicit universal service fund. In addition, the Commission must take the $400 million in LTS and more than $300 million from triple DEM weighting out of the per minute access charges and placed into the new USF. As we noted in our letter to the Commission on March 28, 1997, MCI would not change the amount of universal service funding for non-price cap LECs. Rather, we believe these programs should be moved at their fully funded levels into the new USF. This will encourage greater competition by permitting competitors entering smaller markets to obtain universal service funds when serving rural customers.

There can be no doubt that today's access charges, which all admit are far above cost, are being used to subsidize universal service. (See e.g., In the Matter of Access Charge Reform CC Docket No. 96-262, Notice at para. 40; USTA Comments at 3; MCI Comments at 8; Implementation of Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order at para. 717.) Since the removal of the universal service dollars from access charges does not bring access rates below the $0.011 per minute which the LECs claim as their actual cost in the record, the ILECs will not even be able to make a credible takings argument. MCI, of course, believes the Commission should adopt TELRIC rates for access which cannot be a taking because it includes a reasonable profit.

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EX PARTE

April 18, 1997

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, D.C. 20554

Re: Ex Parte Submission
CC Docket No. 94-1 and 96-262

Dear Mr. Caton:

In response to a staff request, MCI submits the attached material, which computes the LECs' projected and achieved productivity based on their performance under the interim price cap plan. Please associate it with the record in the above captioned dockets.

Respectfully submitted,

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CC: Anthony Bush, James Casserly, James Coltharp, Tom Boasberg, Dan Gonzales, John Nakahata, Greg Rosston

In Attachment 7 of its comments in CC Docket 96-262, filed January 29, 1997, USTA purports to correct an analysis of local exchange carrier (LEC) productivity previously filed by MCI. These "corrections," claims USTA, prove that the LECs' productivity was only 2.85%. However, USTA's analysis is flawed. As described below and in the attached tables, the LECs' choice of productivity factor under the interim price cap plan and their achieved earnings since 1995 indicate that their own assessment of prospective productivity has been between 7.95% and 10.63%. MCI urges the Commission to set the LECs' productivity factor within that range.

MCI's initial analysis examined the LECs' choice of productivity factor at two times. First, it examined the choice of 5.3% in 1995, when the interim price cap plan was adopted. The LECs' choice of 5.3% at that time implied that the LECs expected to achieve productivity of at least 8.54%. Second, the analysis examined the LECs' choice of 3.3% as their productivity factor under the original LEC price cap plan, and found that they would have chosen this productivity factor so long as their expected productivity were no more than 10.86%.

USTA claims that this analysis by MCI is in error because it assumes that the LECs were earning 11.25% when they made their productivity election in 1995. Since the LECs' earnings were in fact 13.78% in 1994, USTA claims, the LECs could have been expecting lower productivity than MCI's analysis shows, and still have chosen an X of 5.3%. In fact, USTA states, duplicating MCI's original analysis but starting from a rate of return of 13.78% results in a break-even X factor of only 2.85%.

USTA's criticism, while making a valid point, is flawed. First, USTA's criticism does not apply to the analysis of the original price cap plan, since the starting point rates under price caps were adjusted to target an 11.25% rate of return. Thus, the LECs' choice of 3.3% in the initial price cap filing indicates that the LECs' expected productivity was no more than 10.86%, as MCI's original analysis showed. Second, while the LECs' rate of return in 1994 is relevant to what their expected productivity level was, USTA has misapplied their earnings in its analysis.

The 13.78% rate of return that the LECs achieved in 1994 is not the correct starting point for the analysis. The Commission required the LECs to take two exogenous adjustments to their price caps, which lowered their revenues without changing their costs. These two changes, removal of Other Post-Employment Benefits and adjusting the cap by 0.7 percentage points for each year the LECs chose a productivity factor of 3.3% under the original price cap plan, lowered the LECs "starting-point" earnings to 11.64%. Given these earnings, the LECs' projected X factor in 1995 would have to have been at least 7.95%, as shown in Table 1. In fact, since the LECs achieved earnings of 13.88% in 1995, their achieved productivity was 10.63%, as shown in Table 1.

This productivity continued into 1996 when the LECs earned 14.98%. Given their 1995 and 1996 earnings, the LECs must have achieved productivity of 7.93% in 1996, as shown in Table 2. Clearly, the LECs' achieved productivity under the interim price cap plan when they have had the greatest incentive to control their costs, has been between 8% and 10%. This is consistent with their election of productivity factor under the original price cap plan, as discussed above. MCI urges the Commission to set the X factor at a level which will reflect the achieved productivity levels of the LECs.

TABLE 1

1994 Price Cap Revenue ($000)	$ 21,618,490	
Net Investment ($000)	$ 30,828,507	
Composite Income Tax Rate	40.00%	
1994 Reported ROR	13.78%	
1994 Reported ROR, adj for OPEB, X-factor adjustment	11.64%	
50/50 Sharing @	12.25%	12.25%
100% Sharing @	13.25%	16.25%

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4%, after sharing	ROR at X = 4.7%, after sharing	ROR at X = 5.3%
3.08%	11.25%	11.25%	10.96%	10.70%
4.26%	11.75%	11.75%	11.46%	11.20%
5.45%	12.25%	12.25%	11.96%	11.70%
6.64%	12.75%	12.50%	12.35%	12.20%
7.83%	13.25%	12.75%	12.60%	12.70%
7.95%	**13.30%**	**12.75%**	**12.63%**	**12.75%**
9.02%	13.75%	12.75%	12.85%	13.20%
10.21%	14.25%	12.75%	13.10%	13.70%
10.63%	**14.43%**	**12.75%**	**13.19%**	**13.88%**
11.39%	14.75%	12.75%	13.35%	14.20%
12.58%	15.25%	12.75%	13.60%	14.70%
13.77%	15.75%	12.75%	13.85%	15.20%
14.96%	16.25%	12.75%	14.10%	15.70%
16.15%	16.75%	12.75%	14.25%	16.20%
17.34%	17.25%	12.75%	14.25%	16.70%

TABLE 2

1995 Price Cap Revenue ($000)	$ 22,110,717	
Net Investment ($000)	$ 32,046,559	
Composite Income Tax Rate	40.00%	
1995 Reported ROR	13.88%	
1995 Reported ROR	13.88%	
50/50 Sharing @	12.25%	12.25%
100% Sharing @	13.25%	16.25%

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4%, after sharing	ROR at X = 4.7%, after sharing	ROR at X = 5.3%
-2.35%	11.25%	11.25%	10.96%	10.71%
-1.15%	11.75%	11.75%	11.46%	11.21%
0.06%	12.25%	12.25%	11.96%	11.71%
1.27%	12.75%	12.50%	12.36%	12.21%
2.48%	13.25%	12.75%	12.61%	12.71%
2.60%	**13.30%**	**12.75%**	**12.63%**	**12.76%**
3.69%	13.75%	12.75%	12.86%	13.21%
4.89%	14.25%	12.75%	13.11%	13.71%
6.10%	14.75%	12.75%	13.36%	14.21%
7.31%	15.25%	12.75%	13.61%	14.71%
7.96%	**15.52%**	**12.75%**	**13.74%**	**14.98%**
8.52%	15.75%	12.75%	13.86%	15.21%
9.73%	16.25%	12.75%	14.11%	15.71%
10.93%	16.75%	12.75%	14.25%	16.21%
12.14%	17.25%	12.75%	14.25%	16.71%

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A CHANGE TO ACCESS CHARGES BASED ON FORWARD-LOOKING COSTS IS FULLY AUTHORIZED UNDER THE ACT AND WOULD BE AN ENTIRELY REASONABLE EXERCISE OF THE COMMISSION'S DISCRETION

The Communications Act Does Not Mandate Traditional Rate-of-Return Methods of Rate-Setting.

As the price-cap regulations illustrate, the Commission has ample authority under section 201 of the Act to depart from rate-setting methodologies that provide a rate of return based on historical costs. In fact, the "just and reasonable" standard in section 201 is no more demanding than the constitutional "just and reasonable" test, which plainly permits rate-setting based on present market value and/or forward-looking costs.

An Historical Practice of Using One Rate-Setting Methodology Does Not Preclude Adoption of a New One, Where There is a Rational Explanation for Such a Change.

The fact that the Commission had an existing practice of basing access charges on historical costs does not mean that it would be "arbitrary, capricious or an abuse of discretion" to change course. A regulatory agency, "faced with new developments or in light of reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrate rulings and practice." American Trucking Ass'ns v. Atchison, Topeka, and Santa Fe Ry. Co., 387 U.S. 367, 416 (1967). As long as it supplies a reasoned explanation, "an agency must be given ample latitude to 'adapt [its] rules and policies to the demands of changing circumstances.'" Motor Vehicle Manuf. Ass'n v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 42 (1983) (quoting Permian Basin Area Rate Cases, 390 U.S. 747, 784 (1968)).

Rates Do Not Become Unconstitutional Because They Require a Company to Write Off Some of its Prior Investments, Even if those Investments Were "Prudent" When Made.

> Access charges based on the current costs of providing access services would not provide ILECs with a guaranteed return on past investments in assets that now constitute excess capacity or use expensive, outmoded technology. But that is not required. Duquesne, 488 U.S. at 315-16; Market Street Ry. v. Railroad Comm'n, 324 U.S. 548, 562 (1945). If that were the constitutional requirement, it would be unconstitutional to subject a formerly regulated monopoly to competition. Thus, in Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993), the court rejected a Takings challenge to a rate order that served to "exclude part of [an] original investment from the rate base." Id. at 1263. Noting that the Commission has no obligation "to include in the rate base all actual costs for investments prudent when made," the court squarely held that, even if the exclusion resulted in a loss of revenues, "there simply has been no demonstration that the FCC's rate base policy threatens the financial integrity of [ILECs] or otherwise impedes their ability to attract capital." Id. Nor could such a showing be made here.

The ILECs Cannot Claim that They Received Some Sort of Unspoken Promise that Rate-of-Return Rate-Setting Would Continue Forever.

There is no basis for the suggestion that regulators made some sort of "compact" with the ILECs, guaranteeing permanent rate-setting based on historical costs. The law has for many decades authorized regulators to change to other methods. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). And by imposing price caps, the Commission has already largely abandoned historical cost as the basis of regulation.

Changed Circumstances Fully Justify a Change to Access Charges Based on Forward-Looking Costs.

The 1996 Telecommunications Act virtually compels a move in the direction of access charges based on forward-looking costs. The Act has opened up local markets, including the market in exchange access, to competition. When that policy succeeds, ILECs will have no choice but to price access based on forward-looking costs. But the move toward competition cannot succeed as long as the ILECs are receiving a huge subsidy in the form of inflated access charges because the ILECs will be able to build an anti-competitive war chest. These unwarranted subsidies can be used by ILECs to solidify their hold on their local monopoly markets.

Moreover, the 1996 Act has also opened up long distance to competition from the RBOCs. In order to prevent unfair competition in this market, it is essential that the RBOCs not be allowed to charge higher access charges to competitors than they will incur in providing access to themselves or an anti-competitive price squeeze is inevitable. This is especially the case if terminating access, which is not subject to competitive market pressures, remains above cost. Furthermore, the provision of an integrated local and long distance product will make identification of cross-subsidy and predatory activities far more difficult to discover. Finally, the 1996 Act requires the elimination of implicit subsidies. Thus, the goal of "universal service" can no longer be used to justify bloated access charges.

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BASING INTERSTATE ACCESS CHARGES ON THE FORWARD-LOOKING COST OF PROVIDING THAT SERVICE WOULD NOT CONSTITUTE A "TAKING"

It is spurious to suggest that it would constitute a "taking" under the Fifth Amendment[1] to require ILECs to sell access to IXCs at rates based on forward-looking economic cost. The Commission itself so recognized in requiring ILECs to provide essentially the same service to local competitors at prices based on the forward-looking cost of each element of service ("TELRIC").[2] Under settled Takings jurisprudence, that conclusion was both correct and fully applicable to the issue of interstate access charges.

The Constitution Does Not Require Access Charges Based on Historical Costs.

Agencies are "not bound to the use of any single formula or combination of formulae in determining rates." Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). A past practice of rate-setting based on historical costs does not bar a change to a new system. See, e.g., Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989); Wisconsin v. Federal Power Commission, 373 U.S. 294 (1963). Nor do utilities have a right to the maintenance of a particular overall level of return. The mere "fact that the value [of the utility's property] is reduced does not mean that the [rate] regulation is invalid." Hope, 320 U.S. at 601.

The Only Constitutional Question is Whether the Overall Rate Structure Jeopardizes the Regulated Utility's Financial Integrity.

Because, as the Hope Court noted, "the rate-making process . . . i.e., the fixing of 'just and reasonable'

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[1] U.S. Const. amend. V ("nor shall private property be taken for public use, without just compensation").

[2] First Report and Order, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, ¶ 736 (August 8, 1996).

rates, involves a balancing of the investor and the consumer interests," id. at 603, regulators have a broad "zone of reasonableness" in setting rates. E.g., In re Permian Basin Area Rate Cases, 390 U.S. 747, 770 (1968). The Constitution only bars overall rates that are so low as to "jeopardize the financial integrity of the [regulated] companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." Duquesne, 488 U.S. at 312 (emphasis added); see also Federal Power Commission v. Texaco, Inc., 417 U.S. 380, 391-92 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level."); Permian Basin, 390 U.S. at 769 ("Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness.").

Rates Based on the Current Economic Cost of Providing a Service, including a Reasonable Return, Cannot, in Principle, Violate the Constitution.

Requiring access charges based on economic cost, including a reasonable return, cannot be unconstitutional. Such rates would allow ILECs to earn a reasonable return on the current market value of the assets being used to provide access. That is all that they could expect to earn in a competitive marketplace. In a period of transition to competition, the Constitution cannot be violated by a rate methodology that "mimics the operation of the competitive market" and "gives utilities strong incentive to manage their affairs well and to provide efficient services to the public." Duquesne, 488 U.S. at 308-09.